

STATEMENT OF  
THE NATIONAL ASSOCIATION OF HOME BUILDERS  
ON

"Tax Reform and the Tax Treatment of Debt and Equity"

July 13, 2011

## Introduction

The National Association of Home Builders (NAHB) appreciates the opportunity to submit this statement on "Tax Reform and the Tax Treatment of Debt and Equity?"

Founded in 1942, NAHB is a federation of more than 800 affiliated state and local building industry associations. It is the voice of the housing industry in the United States. NAHB represents more than 160,000 builder and associate members throughout the country, including individuals and firms that construct and supply single-family homes, as well as apartment, condominium, multi-family, commercial and industrial builders, land developers and remodelers.

Access to household and business debt financing is critical for the operation of a modern economy. Debt enables individuals to finance the purchase of durable goods and to invest in long-term assets. In turn, durable goods and investments provide a stream of benefits over time, and the use of debt aligns the cost of these goods/investments with the flow of their benefits. For most households, the largest investment decision they make will involve the purchase of a home, which is both a durable good (in that it provides a flow of housing services) and an investment (in that it is a capital asset that must be maintained and can be sold for a gain or loss).

## Housing's Economic Impact

Housing plays a central role in the economy. Housing contributes to gross domestic product (GDP) in two basic ways: through private residential investment and consumption spending on housing services. Historically, residential investment has averaged roughly 5 percent of GDP while housing services have averaged between 12 and 13 percent, for a combined 17 to 18 percent of GDP. These shares tend to vary over the business cycle. Residential investment includes construction of new single family and multifamily structures, residential remodeling, production of manufactured homes, and brokers' fees. Consumption spending on housing services includes gross rents (which include utilities) paid by renters, and owners' imputed rent (an estimate of how much it would cost to rent owner-occupied units), and utility payments.

Currently, because of the impacts of the Great Recession housing's total contribution to GDP stands at 14.9 percent. This is in large part due to the ongoing depression in the residential construction sector. Housing starts are down by more than 75% since their peak at the beginning of 2006, with more than 1.45 million jobs lost in the residential construction sector. Home prices are down approximately one-third from 2006 levels, wiping out trillions of dollars of wealth of the nation's 75 million homeowners. Until the nation's housing markets recover, there can be no robust economic recovery for the economy at large. Housing is linked to household wealth, consumer confidence, a healthy labor market (by enabling people to locate from city to city), and the direct jobs impact connected to the housing industry.

NAHB estimates the following economic impacts from home building and remodeling.<sup>1</sup>

Construction of an average single-family home:

- Creates 3.05 jobs and \$145,422 in wage income
- Yields \$85,866 in net business income
- Generates \$89,216 in federal, state and local tax revenue

Construction of an average multifamily unit:

- Creates 1.16 jobs and \$54,938 in wage income
- Yields \$31,771 in net business income
- Generates \$33,494 in federal, state and local tax revenue

Investment of \$100,000 of remodeling improvements:

- Creates 1.11 jobs and \$52,709 in wage income
- Yields \$29,958 in net business income
- Generates \$30,217 in federal, state and local tax revenue

#### Debt Financing is Critical For Home Buyers

To produce these benefits, the housing sector must have reasonable access to debt, which facilitates both supply and demand. Home buyers provide both debt (a mortgage) and equity (cash in the form of a downpayment) when purchasing a home. Very few home buyers—only the wealthy and investors—are financially capable of providing all or most of the home purchase price in the form of cash. As a result, accessible and affordable mortgage financing of a home purchase is an essential element of a functional housing market.

Given these realities the use of debt to finance a home purchase is an unavoidable means. This is particularly true for younger, first-time homebuyers who have less accumulated wealth as they begin their working years. The Joint Committee on Taxation<sup>2</sup> demonstrated this effectively by noting that household leverage declined significantly for households headed by an individual aged more than 45. For household heads aged less than 35, the leverage ratio on average was 44.3 according to the 2007 Survey of Consumer Finances. For those aged 35 to 44, the average ratio fell to 28.2. And for those 45 or higher, the average leverage ratio was less than 16.3.

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<sup>1</sup> The Direct Impact of Home Building and Remodeling on the U.S. Economy. NAHB Economics Group. (<http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=103543&channelID=311> )

<sup>2</sup> Present Law and Background Relating to Tax Treatment of Household Debt. <http://www.jct.gov/publications.html?func=startdown&id=3802>

## The Mortgage interest Deduction

The mortgage interest deduction (MID) is a cornerstone of American housing policy. Deductions for mortgage interest have been allowed for homeowners since the origins of the tax code in 1913. By reducing the after-tax cost of servicing a mortgage, the MID reduces the cost of ownership of a home. This is particularly true for homeowners in the early years of a mortgage, who are paying mostly interest and relatively little principal. For these homeowners, the MID is of great importance.

Under present law, homeowners may deduct interest from up to \$1 million of acquisition mortgage debt and up to \$100,000 of home equity loan debt. These limits were set in 1987 and were not adjusted for inflation. Mortgages connected to a primary residence and one other home qualify for the deduction.

The benefits of the MID are collected predominantly to the middle class. According to estimates from the Joint Committee on Taxation (JCT), nearly 70% of the tax benefits fall to those with economic income of less than \$200,000.<sup>3</sup> It should be noted that economic income is a concept that generates incomes higher than adjusted gross income (AGI) (for example, it includes employer-paid health insurance premiums). These same taxpayers pay only 43% of the income tax paid, indicating that the MID is a progressive feature of the income tax (providing larger benefits to middle income taxpayers as a share of household income). In fact, using IRS data, NAHB has calculated that for taxpayers with AGI less than \$200,000, the MID is worth on average 1.76% of AGI. For taxpayers with AGIs above \$200,000, it is worth less, 1.5% of AGI.<sup>4</sup> 89% of MID beneficiaries earn less than \$200,000 in economic income according to the JCT.

It is sometimes claimed that few homeowners claim the MID because itemization, or filing Schedule A in lieu of claiming the standard deduction, is required. This is false. The JCT estimates reveal that 34.6 million taxpayers claimed the MID for tax year 2009. While this number represents 22% of all tax returns, it is in fact 46% of all taxable returns and nearly 70% of itemizing returns.

The more relevant numbers are the shares of homeowners. There are 75 million homeowners in the U.S., so approximately half *in a given year* claim the MID. However, approximately 25 million of that 75 million own their homes free and clear of a mortgage. This means of homeowners with a mortgage, 70% claim the MID. Of those who do not, most are older homeowners in the later years of the mortgage when they are paying relatively more principal and relatively less interest. For these homeowners, the standard deduction is a better deal.

Using BEA data, NAHB estimates that over the last decade, 86% of mortgage interest paid has been claimed as a deduction on Schedule A. Take together, these numbers illustrate that over the tenure of homeownership, almost all homeowners will claim the MID for years at time, particularly as first-time homebuyers paying large amounts of interest.

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<sup>3</sup> Estimates of Federal Tax Expenditures for Fiscal Years 2010 – 2014.

<http://www.jct.gov/publications.html?func=startdown&id=3718>

<sup>4</sup> Who Benefits from the Housing Tax Deductions?

<http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=150471&channelID=311>

NAHB analysis of IRS Statistics of Income data in fact reveals that the deduction is most valuable for younger home homeowners.<sup>5</sup> 75% of the deduction is claimed by those under age 55. The largest nominal deductions for mortgage interest are claimed by those aged 35 to 45 (with the average deduction totaling nearly \$14,000) and the largest deductions as a share of AGI being claimed by those under age 35 (totaling 12% of AGI).

Moreover, contrary to claims that the MID causes homebuyers to purchase a more expensive home, the data indicate that larger families deduct more mortgage interest because they require a larger home to house their families. NAHB analysis of SOI data confirms this.<sup>6</sup> Taxpayers with two dependents claimed on their tax return who claimed the MID had an average tax benefit of \$1,500. Taxpayers with four dependents had an average benefit of approximately \$1,950. In fact, the benefit increased correspondingly from one dependent to five-plus dependents, which is intuitive with the notion that larger families require larger homes. Moreover, the cost of living, particularly for housing, varies greatly from city to city, so what may appear to be a large deduction for a given home in one area, may in fact reflect a modest home in a high cost area. Indeed, the MID and the real estate tax deductions reflect one of the few elements in the tax code that account for differences in cost-of-living.

#### Public Opinion of the Mortgage Interest Deduction

It is not surprising given the important financial role that the MID plays that polling indicates that it is popular with the American public, homeowners and renters alike. NAHB commissioned a nationwide poll with a bipartisan teaming of Public Opinion Strategies and Lake Research Partners in May 2011. The poll found that 73% of likely voters thought it was reasonable to support housing through the tax code. With respect to the MID, 71% of the respondents opposed eliminating the deduction. And 63% of likely voters oppose any limitation of the present law rules. The support was consistent across party lines, with self identified Republicans, Democrats and independents all opposing limiting the MID by significant majorities.

Interestingly, support for the MID was also high among renters, who are often cited as a group who does not benefit from the deduction. However, this once again overlooks the lifecycle of housing tenure. Nearly 60% of renters opposed eliminating the MID, which makes sense given that 73% of renters aspire to own a home in the future. And despite the ongoing weakness in the housing sector, the poll reveals continued faith in the American dream, with 75% of the respondents reporting that owning a home was the best long-term investment and 95% of homeowners indicating that they were happy with their decision to become homeowners. This is good news for the long-term prospects of the nation's economy and the health of local communities, given the substantial research literature indicating

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<sup>5</sup> Housing Tax Incentives: Age Distribution Analysis.

<http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=137280&channelID=311>

<sup>6</sup> Who Benefits from the Housing Tax Deductions?

<http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=150471&channelID=311>

significant, positive social and individual impacts that come from homeownership, including improved health, education, and civic outcomes.<sup>7</sup>

The New York Times also commissioned a poll that provides confirmation of the NAHB commissioned poll.<sup>8</sup> Regarding the mortgage interest deduction (MID), the Times reported that, "almost no one favors discontinuing the mortgage tax deduction, a prized middle-class benefit that has been featured on some budget-cutting proposals." Other findings of the Times poll indicate that 93% of people believe it is very important (63%) or somewhat important (30%) for the federal government to keep the MID in place.

### Misconceptions of the Mortgage Interest Deduction

Another claim of some opponents of the MID is to link the deduction with the housing crisis. Given the worldwide increase in housing prices and the long historical use of the MID, this linkage clearly fails. In fact, the JCT in their report<sup>9</sup>, comparing the changes in tax law and historical debt levels including the years prior to and during the Great Recession, note that "This appears to indicate that the tax rules by themselves do not explain the trends in household debt over this period."

In fact, eliminating or curtailing the MID would have the effect of increasing the cost of purchasing a home, thus reducing demand for homes and placing downward pressure on home prices, thus exacerbating the current economic crisis. Given what has happened the nation's housing markets, and its related and spillover consequences for that nation's economy, changing the rules with respect to home buyer demand and mortgage access is exactly what the economy does not need. Some critics of the MID claim that a reduction in house prices would "improve" affordability for home buyers. This claim assumes the homebuyer is using cash and no debt however. However, if the price of homes fell less than the after-tax increase in servicing the debt, affordability would be hurt by limiting the MID. Not to mention that this view ignores the impact declining prices has on the wealth of all the nation's current homeowners.

Others have suggested long-term phase-ins of various limits for the MID. However, these proposals would also have immediate and negative consequences for housing. The typical homebuyer remains in their home for approximately 10 years.<sup>10</sup> Given the long-term nature of a home purchase, changes that would become effective in two, five or even ten years would have the consequence of reducing housing demand, and prices, today. And these changes would affect not only potential homebuyers, but all existing homeowners in terms of generating a windfall wealth loss through housing price declines.

Other specific limitations that have been debated concerning the MID would also have harmful impacts. Some have suggested eliminating the deduction for a second home. Perhaps such a proposal calls to

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<sup>7</sup> The Social and Private Micro-consequences of Homeownership. Robert Dietz and Donald Haurin. Journal of Urban Economics. 2003. <http://www.sciencedirect.com/science/article/pii/S0094119003000809>

<sup>8</sup> [http://www.nytimes.com/2011/06/30/business/30poll.html?\\_r=2&hp](http://www.nytimes.com/2011/06/30/business/30poll.html?_r=2&hp)

<sup>9</sup> Present Law and Background Relating to Tax Treatment of Household Debt. <http://www.jct.gov/publications.html?func=startdown&id=3802>, page 48.

<sup>10</sup> How Long Buyers Remain in Their Homes. NAHB.

<http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=110770&channelID=311>

mind expensive beach homes (regardless of whether such homes are more likely to be owned by higher-income families who own the home free and clear of a mortgage or rent out the home, with the mortgage interest expense a business deduction, not an MID). In practice, the second home deduction is important for many households who in fact do not think of themselves as owning two homes. For example, the second home deduction facilitates claiming the MID during a period of homeownership transition, when a family may own two separate principal residences in a given tax year. Without the second home MID, this family would only be able claim an interest deduction on a portion of their total mortgage interest payment. Further, the second home MID rules allow up to 24 months of construction loan interest on a newly-constructed home to be claimed while the family resides in their existing principal residence. This rule provides parity for owner-built home building for which the eventual homeowners assumes the role of the builder and finances the cost of construction.

Overall, repeal of the second home MID rules would have negative economic consequences throughout the nation in terms of lost home sales, home construction, as well as price impacts. And those price declines would of course be more significantly realized in those areas of the country for which second home ownership is more common. The top areas with high numbers of second homes may be surprising; a preliminary NAHB analysis of American Community Survey data from the Census Bureau indicates, for example, that of the counties which has the largest stocks of homes that most closely match the tax code's definition of a second home (a broader definition than simply seasonally vacant properties) two are in Colorado, two are in Utah, and one each in Pennsylvania, Michigan, New York, Alaska, California and Massachusetts. This indicates that the scope of impact would be significantly larger than simply coastal beach homes, totaling 7 to 12 million homes.

Another element of the MID that has been criticized are the rules allowing an interest deduction for home equity loans. It is important to keep in mind that according to the 2009 American Housing Survey, half of all home equity loans are used for remodeling purposes. Remodeling is of course another form of housing investment which creates jobs and improves the nation's housing stock, particularly with respect to energy efficiency. Disallowing a deduction for interest for home remodeling provides a disincentive for homeowners to improve the nation's existing housing stock and hurts job creation in the remodeling industry.

#### Business Debt Tax Issues for Home Builders

The use of debt is also critical for the supply side of the housing market. The home building industry is dominated by small businesses. And small businesses in the residential construction sector depend on debt to finance business operations, make payrolls, and build and build or improve homes.

The median NAHB home builder member has 4 employees, constructs 3 homes per year, and reports less than \$1 million in gross receipts. Approximately 80% of NAHB's membership consists of businesses organized as non C-Corporation entities (sole proprietorships, partnerships, LLCs and S Corporations). And very few of the 20% of members organized as C Corporations are publicly-traded corporations.

For such small firms, equity financing from Wall Street is simply not an option. The average NAHB member, be they a land developer, remodeler, or home builder, must seek business financing in the

form of debt from banks. For builders, this typically takes the form of Acquisition, Development and Construction (AD&C) loans. It is typical with such loans for small businesses to offer up personal guarantees (effectively using personal assets as collateral) in order to attract capital to small business.

For these reasons, the tax treatment of debt and the prospects for a recovery in housing and the economy as a whole are directly related. Policy actions that would increase the cost of debt for homebuyers and small businesses in the housing sector would prevent job creation, undermine emerging stability in housing prices, and weaken an already lagging economic recovery after the deepest recession since the Great Depression.

Small business lending is in a state of crisis, particularly for those firms in the residential construction industry. According to FDIC Statistics on Banking data, since the fourth quarter of 2007, loans outstanding for ADC home building purposes have fallen from \$203 billion to \$56 billion, a decline of nearly 74%. While some of this decline is explained by the fall in housing construction activity, during this same period total housing starts fell only 40%. A significant gap has opened between actual demand for new home building (housing starts are currently at a 560,000 seasonally-adjusted annual rate) and business lending available.

For those builders who are able to get debt financing, interest expense deductibility is critical. Limiting deductions for these loans would raise the cost of business for small firms and drive many out of business, reducing job creation and competition for the sale of new homes. And the alternative, equity financing, is simply impractical for small business.

A final note concerning multifamily developers and carried interest is important to make in the context of access to capital. A carried (or promoted) interest is a profits interest in a business deal that is larger as a share of the total return than the share of the initial equity investment. Under present law, if the income paid out as the carry is a capital gain, then the carry is taxed at capital gains tax rates (in general, up to 15%).

Despite the focus on the financial sector, the use of carried interest is actually quite common in real estate. A builder/developer will typically gain a carried interest in partnership with outside limited partners, who will invest a significant share of the initial equity for a project. The builder provides also provides some equity, but additionally acts as the entrepreneur and takes more of the economic risk. The return to the carry reflects this risk premium, and thus allows shifting the risk away from the limited partners and attracting capital to the deal.

For multifamily projects, the income due to a carry typically arises as profit from the sale of an apartment building, which is a depreciable, capital asset. As such, this profit originates as a capital gain. The proposal to tax carried interest would redefine such income as non-capital income and tax it at a higher rate.

NAHB analysis found that by placing downward pressure on the prices of apartment buildings and other commercial real estate, the proposal would reduce state and local property tax revenues by more than \$1 billion per year and would eliminate more than thirty thousand jobs in multifamily construction and



development. Given the ongoing weakness in the labor market and the potential for job creation in the multifamily sector, tax increases on apartment developers would be harmful for economic growth.